United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-2627

United States Court of Appeals

For The Second Circuit

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P/S

No. 74-2627

PEERLESS MILLS, INC.,

Plaintiff-Appellant,

against

AMERICAN TELEPHONE AND TELEGRAPH COMPANY,

Defendant and Third-Party Plaintiff-Appellee,

against

HERTZ, WARNER & CO., a partnership and NORMAN CARNEY, PAUL COHN, VINCENT GENNA, MARTIN GILMAN, JOEL HELD, IRVING HERTZ, LOUIS KULIKOFSKY, JAY LEYNER, MILTON LITT, CHARLES MATTHEWS, ROBERT SADLER, JAMES SADLER, ROBERT SADLIER, JAY SALUC, KENNETH SHELDON and HENRY WARNER, general partners in Hertz, Warner & Co.,

Third-Party Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

PLAINTIFF-APPELLANT'S BRIEF

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PEERLESS MILLS, INC.,

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HERTZ, WARNER & CO., a partnership and NORMAN CARNEY, PAUL COHN, VINCENT GENNA, MARTIN GILMAN, JOEL HELD, IRVING HERTZ, LOUIS KULIKOFSKY, JAY LEYNER, MILTON LITT, CHARLES MATTHEWS, ROBERT SADLER, JAMES SADLER, ROBERT SADLIER, JAY SALUC, KENNETH SHELDON and HENRY WARNER, general partners in Hertz, Warner & Co.,

Third-Party Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

PLAINTIFF-APPELLANT'S BRIEF

Statement of the Case

This is an appeal from so much of a judgment of the District Court, Marvin E. Frankel, J., entered on November 6, 1974, which dismissed plaintiff, Peerless Mills, Inc.'s

(appellant) claims against defendant, American Telephone & Telegraph Company (AT&T), and third-party defendants Hertz, Warner & Company (HW&Co.), Irving Hertz (Hertz) and Henry Warner (Warner).

In this action, appellant seeks to recover the value of 2,000 shares of AT&T common stock which it transferred to the brokerage firm of HW&Co. to fund the capital contribution of Paul Cohn (Cohn), an incoming partner. Appellant has alleged three claims for relief. The claims against HW&Co., Hertz and Warner arise out of acts of conversion, fraud and deliberate breach of fiduciary obligations. In substance, appellant alleges that the AT&T stock was wrongfully converted and retained by HW&Co., Hertz and Warner upon the failure of Cohn to become a partner in the firm of HW&Co. as a matter of law. Alternatively, appellant also seeks to recover the value of the securities on the ground that HW&Co., Hertz and Warner fraudulently induced appellant to loan Cohn the stock to make his capital contribution to HW&Co.

Finally, appellant seeks to recover the same 2,000 shares of AT&T stock from AT&T. The gravamen of this claim is that AT&T in breach of its statutory duty of inquiry wrongfully transferred the securities to HW&Co. over a valid "stop transfer" placed on the securities by appellant.

The action was tried before Judge Frankel without a jury. The District Court's Findings of Fact and Conclusions of Law were filed on October 31, 1974.

Issues Presented

The central issues on this appeal involve questions of law, the answers to which will have a far reaching effect in the field of commercial law and, in particular, the securi-

Stock Exchange member firm are under an affirmative duty to disclose to an incoming partner that the firm was suffering severe financial reversals. Specifically whether they were under a duty to reveal that:

(a) the firm sustained substantial monthly operating losses;

(b) substantial amounts of limited and subordinated capital had been withdrawn which resulted in a substantial adverse change in the capital structure in the firm; and

(c) certain intended partners failed to sign and accept the proposed agreement and make their capital contributions in accordance with its terms.

The District Court held that there was no such duty. Instead it found that no fraudulent statements or omissions were made to the incoming partner and, therefore, held that no fraud had been committed.

(3) Whether appellee, AT&T, is liable to appellant for the return of 2,000 shares of AT&T common stock since AT&T, after receipt of a "stop transfer" order, mistakenly and wrongfully transferred the securities in breach of its statutory duty of inquiry.

The District Court dismissed this claim since it found that appellant was not the true owner of the securities in question and the "stop transfer" was, therefore, ineffective to impose a duty of inquiry upon AT&T.

The Facts

In 1963, shortly after his entry into the securities industry, third-party defendant Cohn was invited to become a founding partner of the securities brokerage firm of Hertz,

Neumark & Warner (HNW), the predecessor to HW&Co., a limited partnership and member firm of the New York Stock Exchange (NYSE). (76a)* In 1965, Cohn withdrew as a partner from HNW because of the failure of the other partners to involve him in policy matters and decisions. (76a, 110a)

Cohn remained with HNW and its successor, HW&Co., as an employee, functioning as a registered representative. (77a, 111a) During the course of his employment, Cohn began to assume responsibility in the area of syndication and eventually formed HW&Co.'s syndication department where he worked directly under third-party defendant Warner. (77a, 78a)

In 1968, Cohn married Leslie Fine, the daughter of A. C. Fine, then president and sole shareholder of Peerless Mills, Inc., the family holding company. Both Hertz and Warner attended Cohn's wedding and reception at the Plaza Hotel in New York City where they met Mr. and Mrs. Fine. (131a, 240a, 274a)

Cohn's Partnership Discussions with Warner, Hertz and Appellant

As his responsibilities in syndication increased, Cohn's activities and commissions as a registered representative decreased proportionately. (77a, 78a, 79a) Consequently, from about the fall of 1968, Cohn sought additional compensation from Warner. (79a) Cohn was earning approximately $33,000 per year at this time. (79a)

In March or April, 1969, Warner stated to Cohn that, in view of his outstanding performance, the firm would offer him a 3% partnership interest effective July 1, 1969. In substance, Warner, on behalf of HW&Co., offered Cohn the terms of a non-negotiable partnership offer. Cohn, as

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* Parenthetical references are to the Joint Appendix.

a partner, would share 3% of the firm's profits and assume 4½% of its losses. In addition, Warner told Cohn that he would receive an annual salary of $15,000. There was no discussion of a capital contribution at the time the partnership offer was initially made. (80a)

Cohn expressed to Warner his concern that the annual salary offered, which was less than half of his present annual income, would not be sufficient. (80a, 81a) In response, Warner illustrated to Cohn the reasons why the $15,000 salary figure was just a bare minimum figure. (80a, 81a) Warner advised Cohn that HW&Co. had earned a profit of $2.5 million from its operations in the prior fiscal year* and had already earned over $1 million during the period July 1, 1968 through January, 1969. Warner also stated that there was no reason to believe that profits would not continue at the same rate through June 30, 1969. (84a, 85a, 120a, 121a) Therefore, applying Cohn's partnership participation of 3% to these figures, Warner made it clear that despite the $15,000 annual salary, Cohn would earn a handsome income. Warner did not disclose to Cohn that HW&Co. was incurring substantial losses in its present operation, which losses in the second half of the fiscal year would wipe out the earnings of the first half. (80a, 81a)

Cohn was quite happy with the fact that the firm recognized and acknowledged his efforts in the area of syndication and with the opportunity to substantially increase his income. (80a, 81a) He discussed the partnership opportunity with his father and with his father-in-law, Fine. Cohn related to Fine the conversation he had had with Warner wherein Warner used the example of $1 million to project Cohn's potential earnings as a partner. (81a, 131a, 132a)

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* HW&Co.'s fiscal year runs from July 1 through June 30.

Cohn also discussed the partnership opportunity with Hertz. (82a, 83a) Over the years, a close and confidential relationship had developed between Cohn and Hertz. (235a, 241a, 242a) In point of fact, Hertz had rendered advice to Cohn on many matters in the past. (235a, 241a, 242a) On this occasion, Hertz told Cohn that he was happy with the idea of Cohn becoming a partner and that he should accept the firm's offer. (82a, 83a)

Cohn had continuing discussions with Warner during April, 1969 concerning the $15,000 proposed salary figure. Warner simply stated that the $15,000 salary was not negotiable. He reiterated, however, that the firm had earned $1 million for the first six months of fiscal 1969; that it was continuing to prosper; and that Cohn could justifiably project this $1 million figure in computing what his share of the profits would be. (Cohn 20, 21) Cohn continued to advise appellant of the substance of these conversations with Warner. (86a, 87a, 131a, 132a)

After considerable deliberation, Cohn, in the latter part of April, 1969, told Warner that he would accept the partnership offer. (83a) It was at this time that Warner told Cohn that he would be expected to make a capital contribution of $100,000 to the firm. Cohn told Warner that he did not have the money and that, obviously, he would have to borrow. Thereafter Cohn again discussed the partnership opportunity and the required capital contribution with Fine. Fine agreed to loan Cohn the required capital to enable him to accept the HW&Co. partnership opportunity. (44a, at ¶ 29)

Shortly after this conversation, Cohn indicated to Warner that he could borrow the required capital from appellant and that the capital borrowing would be in the form of securities. (83a, 84a) This came as no surprise to either Hertz or Warner as they were both aware from the outset

of the partnership discussions that appellant would be available as the source of funds for Cohn's capital contribution. (Pltf. Exh. 20, at 22-23)

Hertz, Warner & Co.'s Actual Financial Condition

Throughout the course of discussions concerning partnership, neither Hertz nor Warner disclosed to Cohn the financial results of HW&Co.'s operations during February, March and April, 1969. (84a, 85a) When Cohn asked Warner about the firm's present financial picture, Warner told him that the firm had "booked" $1 million in profits for the first six months of fiscal 1969 and that there was no reason to believe that these profits would not continue throughout the fiscal year. (84a, 85a)

In point of fact, however, HW&Co. was incurring substantial monthly losses from its operations at the time Warner and Hertz discussed the partnership opportunity with Cohn. From February 1, 1969 through June 30, 1969, HW&Co. lost $1,051,180. (46a, at ¶ 44) In other words, during the latter part of fiscal 1969, HW&Co. lost most of the money that was made during the first part of that fiscal year. (Pltf. Exh. 20, at 146)

Hertz admitted that the precipitous and substantial losses started as of February, 1969 and were known to him. (Pltf. Exh. 20, at 146) Indeed, throughout the operation of the firm, Hertz and Warner received and reviewed regular monthly profit and loss summaries. (46a, at ¶ 46) Hertz stated that he did not make full distribution of the monthly statements because of competitive reasons. (Pltf. Exh. 20, at 50) These monthly profit and loss summaries, among other records, reflected the substantial monthly losses HW&Co. was sustaining. In point of fact, Hertz was always aware of the financial condition of HW&Co. (Pltf. Exh. 20, at 69) In his discussions with Cohn, Hertz stressed

the high earnings of the last six months of 1968. However, he did not mention the losses of the early months of 1969 which would eradicate the earnings for the first six months of fiscal 1968-69. (62a)

In addition to the substantial monthly losses which HW&Co. was incurring, the bulk of HW&Co.'s subordinated loans were due to terminate in December 1969. (263a, 264a; Pltf. Exhs. 3, 4) In fact, the firm was returning substantial amounts of limited and subordinated capital. (61a) Efforts to replace this critical capital were unsuccessful since the subordinated loans in the firm did, in fact, expire in December 1969. These circumstances resulted in a substantial adverse change in the capital structure of HW&Co. in January 1970 which was due primarily to the retirement and withdrawal of limited partners and subordinated lenders capital. (Pltf. Exh. 3) Hertz was aware of these facts, but made no effort to disclose them to Cohn or appellant. (263a, 264a)

Despite the fact that both Hertz and Warner were aware of this adverse financial condition, neither one made any disclosure to Cohn. Similarly, no disclosure was made to appellant, the known source of Cohn's capital contribution. To the contrary, the representations made to Cohn, and in turn to appellant, were that the firm was prospering.*

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* Hertz and Warner's discussions with Cohn are strikingly similar to those had with Joel Held, another incoming partner under the proposed 1969 agreement. In May 1969, Warner offered Held the position of general counsel and partner and emphasized that the firm was prospering. Warner did not advise Held of the actual financial condition of the firm and of the substantial monthly losses which were being incurred at that time. (157a, 167a) Indeed, in response to Held's request for current financial statements, Warner stated that none were available. (157a, 158a)

The Status of Meyer and Blau

Arthur Meyer (Meyer) and Joseph Blau (Blau) were limited partners in HW&Co. and were the principal spokesmen for a significant group of limited partners called the "Meyer-Blau group". Under the terms of the 1968 HW&Co. Articles of Limited Partnership, Meyer, Blau and their group were limited partners with a total capital contribution of $1,722,000. No member of the group participated in the risk of loss under the terms of the 1968 agreement.

The critical importance of the group to the capital structure of HW&Co. was continually emphasized by Hertz. In point of fact, Meyer and Blau were designated as "special limited partners" (163a) in the earlier drafts of the proposed 1969 agreement in that they were to be responsible for a portion of the firm's losses. (Pltf. Exh. 20, at 117) Indeed, at one point, Hertz and Warner took the position that Meyer and Blau were in fact general partners of the firm. (Pltf. Exh. 20, at 118)

From at least as early as June, 1969, Hertz conferred with Meyer and Blau concerning their status under the proposed 1969 HW&Co. partnership agreement. (213a, 214a) Specifically, Hertz asked Meyer and Blau to increase their capital contribution to the firm from $150,000 to $300,000 each in exchange for increased participation in the profits. (214a, 215a, 216a) This raised the total capital investment of the Meyer-Blau group to approximately $2 million. (Pltf. Exh. 1) In addition, Hertz sought to have Meyer and Blau assume a percentage of the firm's losses. The proposed 1969 agreement provided that Meyer and Blau would assume 18% of the firm's losses. (Pltf. Exh. 1) These discussions continued through the summer and fall of 1969 and culminated in Meyer and Blau presenting certain counter-proposals (217a; Pltf. Exh. 19) to which Hertz could not agree. (218a, 219a; Pltf. Exh. 20, at 36)

In substance, the unacceptable Meyer counter-proposals (Pltf. Exh. 19) required broad and sweeping changes to the proposed partnership agreement. Specifically, the general partners of the firm would be required to cure any deficiency in the capital accounts within 15 days of the computation of the deficiency. If the general partner failed to make an additional contribution to cure the deficiency, then his participation in the profits of the firm would be proportionately reduced. In addition, Meyer proposed that no limited partner would be required to make any additional capital contributions by reason of the diminution in the value of the securities contributed by him to HW&Co. This proposal greatly disturbed Hertz and was never approved. (260a) In addition, the Meyer counter-proposals stated that if any member of the HW&Co. executive committee withdrew from the firm, then the partnership would terminate. This proposal was not acceptable to Hertz and was not incorporated in the final 1969 partnership agreement. (Pltf. Exh. 1)

At no point did Meyer or the group he represented accept the terms of the proposed HW&Co. agreement. (222a, 223a; 45a, at ¶ 35) Moreover, at no time during the course of discussions with Hertz did Meyer agree to sign the proposed 1969 agreement unless and until his counter-proposals, which Hertz would not agree to, were incorporated into the partnership agreement. (221a, 222a) Indeed, Meyer and Blau consistently repudiated the 1969 agreement and took the position that their rights were governed solely by the 1968 agreement. (Pltf. Exh. 25)

Neither Cohn nor appellant was made aware of the precarious state of negotiations between the critically important "Meyer-Blau group" and Hertz, or the substantial monthly losses which HW&Co. was incurring. Indeed, the frenetic state of business activity during the summer and fall of 1969 created quite a different impres-

sion. A large staff, new office construction, underwritings and daily conferences on new business, including retail and institutional, created the impression of a vibrant and healthy business. (157a, 158a)

The Delivery of the AT&T Stock by Appellant to HW&Co.

In October, 1970, Hertz pressed Cohn to make his capital contribution. (88a, 89a) Hertz advised Cohn that HW&Co. had submitted the "partnership agreements and (Cohn's) financials to the Exchange." (Pltf. Exh. 20, at 56-57) In fact, as of this time, the final draft of the proposed partnership agreement had not been completed. (Pltf. Exh. 8)

Since Hertz was aware that Cohn's capital contribution would be made in the form of AT&T securities owned by appellant, he directed that the loan agreement for appellant be prepared by Held on behalf of HW&Co. (176a, 177a; Third-Party Def. Exh. B) Appellant and Cohn were then required to sign the loan agreement. The 2,000 shares of AT&T common stock were delivered directly from appellant to HW&Co. so that Cohn could make his capital contribution in accordance with the terms of the proposed July 1, 1969 partnership agreement. (135a, 139a, 177a; 44a, at ¶ 32)

On November 19, 1969, the 2,000 shares of AT&T stock delivered by appellant were registered in the name of HW&Co. (40a, ¶ 6) Prior to the time appellant delivered the AT&T stock to HW&Co. neither Hertz nor Warner disclosed to Cohn or appellant that HW&Co. had not had a profitable month since January 1969 and, in fact, had incurred substantial losses since that time. Moreover, prior to the delivery of the stock, HW&Co. did not disclose to Cohn or appellant the status of the Meyer/Blau negotiations.

The Execution of the 1969 Agreement

Upon assuming his role as general counsel in June 1969, Held began to draft the HW&Co. Articles of Limited Partnership for 1969. (159a) The drafting project was a long, on-going process with many changes occurring in the numerous drafts. (160a, 161a) Finally, on November 21, 1969 the HW&Co. Articles of Limited Partnership, dated July 1, 1969, were completed and circulated by Held for signature. (Pltf. Exh. 8) Cohn received a copy of the agreement sometime in late November or early December, 1969. (86a, 87a)

In reading the proposed agreement, Cohn noted the substantial amount of capital which was to be contributed by the Meyer-Blau group and the percentage of losses to be assumed by Meyer, Blau and Schiff who were designated limited partners in the proposed agreement. (86a, 87a) By the express terms of the proposed 1969 agreement, Meyer and Blau were to contribute $300,000 each in capital. The total capital contribution of the Meyer-Blau group was to be approximately $2 million. (Pltf. Exh. 1) The proposed agreement also evidenced the fact that Meyer and Blau would be responsible for 18% of the firm's losses.

In or about late November or early December, 1969, Held asked Cohn to sign the partnership agreement. (87a, 166a, 167a) Held had already signed the agreement based upon assurances from Hertz that all of the parties to the agreement would sign and that Meyer and Blau had, in fact, signed and accepted the agreement. (167a)

When Held approached Cohn to sign the proposed agreement, Cohn expressed concern about Meyer and Blau and asked Held if they had signed. (87a, 167a) Held informed Cohn that Hertz had told him that both Meyer and Blau had signed the agreement. (87a, 88a, 166a) In point of fact, however, neither Meyer, Blau nor any of

the Meyer-Blau group at that time had signed the agreement. It appears that Hertz did not even disclose this fact to Warner. Indeed, at no time did Meyer or Blau or their group sign and accept the proposed July 1, 1969 HW&Co. partnership agreement. (45a, at ¶ 35; Pltf. Exh. 25)

Prior to the time Cohn executed the proposed agreement neither Hertz nor Warner disclosed to him the continuing and substantial losses that HW&Co. was incurring. Cohn had not been shown the monthly statements which Hertz and Warner were receiving. (88a) Indeed, Cohn did not even know of the existence of the statements. (88a) Apparently, Hertz and Warner had not disclosed the firm's financial reversals to anyone. There was no disclosure to Held prior to the time he signed the 1969 agreement. (167a) Throughout the summer and fall of 1969, Held had asked Hertz and Warner about the results of fiscal 1969 since many of the limited partners and other investors in the firm had asked him for the same information. On each occasion, Held was told that the results were not available. (188a)

Efforts to Obtain Information

During the fall of 1969, there were weekly HW&Co. executive committee meetings. However, Cohn and the other younger partners were not invited to attend. During this period, Cohn could recall only two or three full partnership meetings which Cohn described more as social gatherings rather than working business sessions. (90a)

Faced with this inability to obtain information, the younger partners who had recently been admitted called on the executive committee to allow them more participation in the affairs of the firm. (92a, 93a, 167a, 168a) Significantly, the younger partners asked for regular profit and loss summaries and for a weighted vote on the execu-

tive committee. While Hertz promised to provide monthly profit and loss summaries, both requests were never complied with. (168a) Hertz also advised the younger partners that Meyer and Blau's acceptance of the 1969 agreement was not the concern of the younger partners and that he was attending to it. (92a, 93a)

Discovery of the Losses

In late December, 1969, the financial results for the fiscal year ending June 30, 1969 were released (169a) and Cohn, for the first time, learned that HW&Co. had lost over $1 million for the last half of that fiscal year. (89a) Held, upon reviewing HW&Co.'s financial statement, dated November 2, 1969, which was not published until on or about December 28, 1969, also learned of the $1 million loss for the first time. (169a) While Cohn's recollection as to specific dates is not that clear, he did recall that at the time the loss was announced, Hertz, at a meeting of general partners, advised that the firm had incurred additional losses of between $750,000 to $1 million subsequent to July 1, 1969. (90a, 91a) Cohn was stunned by the disclosure. At another partnership meeting, he called upon all the general partners to cure any deficiencies in their capital accounts. (91a) He confronted Hertz on the status of Meyer and Blau, and was assured by Hertz that there was no problem. (91)

Deeply disturbed by the recent disclosures, the lack of critical information available to young partners and by their lack of authority, Cohn, in January and February, 1970, discussed the matter with Held. (92a, 93a) In February 1970, it was decided that Cohn and Held would seek the aid of an attorney. (92a, 93a, 170a) Both Cohn and Held went to the law firm of Javits & Javits who advised them that it appeared that they were fraudulently induced to enter the partnership. However, substantial

proof would be required in order to reach a definitive conclusion. (94a)

Cohn then began to investigate the affairs of HW&Co. (94a) He checked into the status of capital accounts and became aware of a substantial capital deficiency in Meyer and Blau's accounts as well as in the account of Norman Carney under the terms of the proposed 1969 agreement. (Pltf. Exh. 12) Cohn also learned that Robert Sadlier had made no capital contribution. Cohn, for the first time, discovered that Meyer and Blau, their group, and other partners had not signed the 1969 partnership agreement.

In addition to the facts uncovered by Cohn, certain other salient facts concerning the proposed 1969 agreement also came to light. Nineteen intended partners, including four general partners, did not sign the proposed 1969 HW&Co. limited partnership agreement. (182a; Pltf. Exh. 21) The proposed agreement was never filed in the New York County Clerk's Office (45a, at ¶ 36) or with the N.Y.S.E. (Pltf. Exh. 11) HW&Co. did not obtain the written consent or ratification of all the then limited partners of HW&Co. on the proposed admission of Cohn as a partner pursuant to the terms of the proposed July 1, 1969 agreement. (44a, at ¶ 34) Moreover, the loan agreement between Cohn and appellant was never submitted to the N.Y.S.E. to obtain its determination that the capital contributed thereunder consituted good capital within the rules of the Exchange. (44a, at ¶ 33)

Protection of the AT&T Stock

Upon discovering these facts, Cohn discussed possible ways of protecting the AT&T stock with Sadlier. (95a, 96a) Cohn rejected the suggestion that the stock be physically removed from the offices of HW&Co. (96a, 97a) On May 1, 1970, in an effort to protect the securities, Sadlier transferred twenty 100-share certificates of AT&T stock in

the name of HW&Co, into a 2,000 share stock certificate in the name of appellant. The purpose of the transfer was to prevent the negotiability of the stock without prior notice to appellant. (41a, at ¶ 10) Despite the fact that Warner had removed capital (Pltf. Exh. 12) and other partners had not made their capital contributions, the securities were never removed from the premises of HW&Co.

In the latter part of April 1970, HW&Co. formally announced its decision to liquidate the firm. (297a, 298a) From that date on, the firm no longer engaged in the stock brokerage business and began the process of liquidating the assets of the firm. It should be noted that on April 13, 1970, or just a short time prior to the decision to liquidate the firm, Warner had removed 2,000 shares of Republic National Bank of New York common stock from his capital account.* (Pltf. Exh. 12) At the time of this withdrawal, Hertz directed Held to write to Warner, seeking the reason, purposes and motives behind the unauthorized removal. (Pltf. Exh. 12)

Cohn now sought further legal advise. He consulted with Zane Klein, an attorney with the law firm of Berlack, Israels & Liberman, who advised Cohn to have appellant place a "stop transfer" on the 2,000 share stock certificate. Cohn was further advised not to remove the stock from HW&Co. (96a)

On July 6, 1970, appellant advised AT&T, which acted as its own transfer agent, that it wished to place a "stop transfer" on stock certificate No. 0471-0429 then registered in its name. (41a, at ¶ 13) The "stop transfer" order sent by appellant was recorded on the books of AT&T on July 6, 1970. (41a, at ¶ 14) On July 7, 1970 AT&T received a letter from appellant confirming the "stop transfer". (Pltf. Exh. 2)

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* At the time Warner withdrew from the firm in April 1970, there was a deficiency in his capital account in the sum of $350,000. (297a)

In August, 1970, Hertz requested Cohn to show him the 2,000 shares of AT&T stock which were then registered in appellant's name. (100a) Cohn complied with this request. (100a) Shortly thereafter, Hertz demanded that Cohn have the securities transferred back to HW&Co. Cohn refused and was eventually suspended from the firm by Hertz. (100a)

On September 15, 1970, HW&Co. presented stock certificate No. 0471-0429, registered in the name of appellant, to AT&T and requested that this stock be transferred from appellant to HW&Co. HW&Co. certified that appellant had no interest in the securities and that HW&Co. would indemnify and hold AT&T harmless for any damages incurred by reason of the transfer. (41a, at ¶ 16)

At the time HW&Co. presented the stock certificate to AT&T for transfer, Joel Held, on behalf of HW&Co., presented a letter of explanation to AT&T. That letter contained a chronological account of the record ownership of the stock. (Pltf. Exh. 15)

On September 17, 1970, AT&T acting as its own transfer agent, transferred the 2,000 shares of AT&T stock registered in the name of appellant to HW&Co. by cancelling certificate No. 0471-0429 and issuing a new certificate in its place, No. 0492-8835. (42a, at ¶ 17) At the time of the cancellation and transfer of stock certificate No. 0471-0429, the "stop transfer" on the certificate had not been withdrawn by appellant and AT&T was aware of the "stop transfer". (42a, at ¶ 18) AT&T did not notify appellant that it had transferred the 2,000 shares of AT&T stock contrary to the "stop transfer" order. (42a, at ¶ 19)

In his letter of September 15, 1970, Held also advised AT&T that "in view of the nature and complexity of the situation surrounding . . . the 2,000 shares of stock, it is of the utmost urgency that [HW&Co.] obtain the requested

documents as soon as possible." (Pltf. Exh. 15) AT&T did not inquire into the "nature and complexity of the situation", nor did it make any inquiry into the basis for appellant's "stop" (42a, at ¶ 20) despite the fact that Held in his letter had traced the chain of record title which evidenced appellant as the original and subsequent record owner. On September 21, 1970, AT&T mailed the 2,000 shares of stock to HW&Co. (43a, at ¶ 22) The securities were then sold by HW&Co. (268a)

On November 11, 1970, appellant wrote to AT&T requesting "a detailed explanation of [the] unauthorized transfer". (Pltf. Exh. 5) On December 17, 1970, AT&T replied to appellant stating that "our Legal Department has given a preliminary review of the case and they have said that a mistake was made in processing this transfer". [Pltf. Exh. 6; 42a, at ¶ 21] On December 22, 1970, AT&T again wrote to appellant stating that on the advice of its Legal Department it had contacted HW&Co. to ascertain the firm's position regarding the matter of the transfer. (Pltf. Exh. 7)

In its *Stock and Bond Instructions—General Information,* AT&T states that when a transfer is requested, it is the responsibility of the transfer office to ascertain whether or not the transfer is duly authorized and to make only those transfers which are so authorized. (43a, at ¶ 24) In addition, the AT&T *Stock and Bond Instructions* state that requests for removing stop transfers must be in writing and proper written authorization is required in order to remove the stop transfer. (43a, at ¶ 25) At the time AT&T transferred the securities from appellant back to HW&Co. on September 17, 1970, it did not ascertain whether or not the transfer was duly authorized. Moreover, it had not received any written request from appellant to remove the stop transfer and did not have the proper written authority to do so.

Summary of the Argument

(1) The District Court erred in holding that Cohn was a partner in HW&Co., as a matter of law, and in holding that the AT&T stock transferred by appellant to HW&Co. to fund Cohn's capital contribution was not converted.

(2) The District Court erred in holding that the principal partners of HW&Co. were not under an affirmative duty to disclose to Cohn material financial information affecting the operations of the firm.

(3) AT&T is liable to appellant for the return of 2,000 shares of AT&T stock since AT&T breached its statutory duty of inquiry.

The Statutes and Rules Involved

New York Partnership Law

§ 91. *Formation*

(1) Two or more persons desiring to form a limited partnership shall

(a) Sign and acknowledge or swear to a certificate, which shall state

I. The name of the partnership.

II. The character of the business.

III. The location of the principal place of business.

IV. The name and place of residence of each member; general and limited partners being respectively designated.

V. The term for which the partnership is to exist.

VI. The amount of cash and a description of and the agreed value of the other property contributed by each limited partner.

VII. The additional contributions, if any, agreed to be made by each limited partner and the times at which or events on the happening of which they shall be made.

VIII. The time, if agreed upon, when the contribution of each limited partner is to be returned.

IX. The share of the profits or the other compensation by way of income which each limited partner shall receive by reason of his contribution.

X. The right, if given, of a limited partner to substitute an assignee as contributor in his place, and the terms and conditions of the substitution.

XI. The right, if given, of the partners to admit additional limited partners.

XII. The right, if given, of one or more of the limited partners to priority over other limited partners, as to contributions or as to compensation by way of income, and the nature of such priority.

XIII. The right, if given, of the remaining general partner or partners to continue the business on the death, retirement or insanity of a general partner, and

XIV. The right, if given, of a limited partner to demand and receive property other than cash in return for his contribution.

(b) File the certificate in the office of the county clerk of the county in which the principal office of such partnership is located. Immediately after the filing of the cer-

tificate, a copy of the same or a notice containing the substance thereof, shall be published once in each week for six successive weeks, in two newspapers of the county in which such original certificate is filed, to be designated by the county clerk, one of which newspapers shall be a newspaper published in the city or town in which the principal place of business is intended to be located, if a newspaper be published therein; or, if no newspaper is published therein, in the newspaper nearest thereto, and proof of such publication by the affidavit of the printer or publisher of each of such newspapers must be filed with the original certificate.

(2) A limited partnership is formed if there has been substantial compliance in good faith with the requirements of subdivision one of this section.

§ 98. *Rights, powers and liabilities of a general partner*

(1) A general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to

* * *

(e) Admit a person as a general partner.

Rules of the New York Stock Exchange

Rule 313. *Submission of Partnership Articles—Submission of Corporate Documents*

(a) All partnership articles and all amendments thereto shall be submitted and be acceptable to the Exchange prior to becoming effective.

§ 8-315. *Action Against Purchaser Based upon Wrongful Transfer*

(1) Any person against whom the transfer of a security is wrongful for any reason, including his incapacity, may against anyone except a bona fide purchaser reclaim possession of the security or obtain possession of any new security evidencing all or part of the same rights or have damages.

(2) If the transfer is wrongful because of an unauthorized indorsement, the owner may also reclaim or obtain possession of the security or new security even from a bona fide purchaser if the ineffectiveness of the purported indorsement can be asserted against him under the provisions of this Article on unauthorized indorsements (Section 8-311).

(3) The right to obtain or reclaim possession of a security may be specifically enforced and its transfer enjoined and the security impounded pending the litigation.

§ 8-403. *Limited Duty of Inquiry*

(1) An issuer to whom a security is presented for registration is under a duty to inquire into adverse claims if

(a) a written notification of an adverse claim is received at a time and in a maner which affords the issuer a reasonable opportunity to act on it prior to the issuance of a new, reissued or re-registered security and the notification identifies the claimant, the registered owner and the issue of which the security is a part and provides an address for communications directed to the claimant; or

(b) the issuer is charged with notice of an adverse claim from a controlling instrument which

it has elected to require under subsection (4) of Section 8-402.

(2) The issuer may discharge any duty of inquiry by any reasonable means, including notifying an adverse claimant by registered or certified mail at the address furnished by him or if there be no such address at his residence or regular place of business that the security has been presented for registration of transfer by a named person, and that the transfer will be registered unless within thirty days from the date of mailing the notification, either

(a) an appropriate restraining order, injunction or other process issues from a court of competent jurisdiction; or

(b) an indemnity bond sufficient in the issuer's judgment to protect the issuer and any transfer agent, registrar or other agent of the issuer involved, from any loss which it or they may suffer by complying with the adverse claim is filed with the issuer.

THE ARGUMENT

POINT I

The District Court erred in holding that Cohn was a partner of HW&Co. as a matter of law and in holding that the AT&T stock transferred by appellant to HW&Co. to fund Cohn's capital contribution was not converted.

A critical issue raised on this appeal is whether, as a matter of law, the HW&Co. Articles of Limited Partnership, dated July 1, 1969, were effective to admit Cohn as a partner. Appellant argued below that Cohn intended to become a partner in accordance with the express terms and conditions set forth in the proposed partnership agreement. (Pltf. Exh. 1) Indeed, the specific terms of the proposed

agreement provide the best evidence of Cohn's contractual intention and constitute the express conditions on which Cohn sought to assume partnership status in the firm of HW&Co.

Thus at trial, appellant argued that the failure of at least nineteen intended partners to sign and accept the terms of the proposed agreement, make their capital contributions and accept their loss ratio totally frustrated Cohn's contractual intent and prevented the requisite meeting of minds so fundamental to the formation of a binding contractual relationship. This repudiation of the proposed agreement when coupled with the failure of HW&Co. to file the agreement with the NYSE for its approval or with the New York County Clerk's Office, as required, established conclusively that there was never a legally operative agreement and that Cohn never became a partner as a matter of law. As a consequence, appellant's 2,000 shares of AT&T stock which were transferred to HW&Co. for the sole purpose of funding Cohn's capital contribution were wrongfully converted by HW&Co.

The District Court rejected appellant's contention, holding that at the time he signed the proposed agreement Cohn intended to be a partner and placed no reservations or conditions upon the assumption of that status. The lower court concluded that the failure of the intended partners to sign and accept the agreement, make their capital contribution and assume the loss ratio set forth in the agreement is not fatal to the existence of the partnership. In so doing, the District Court erroneously created a separate and distinct agreement in total disregard of the express terms of the proposed 1969 agreement which embodied the essential conditions on which Cohn sought to assume partnership status in HW&Co.

Cohn Never Became a Partner of HW&Co. as a Matter of Law

The singular purpose for the transfer of 2,000 shares of AT&T stock from appellant to HW&Co. was to enable Cohn to make his capital contribution as a partner to the firm of HW&Co. in accordance with the terms of the proposed 1969 partnership agreement. (44a, at ¶ 29) Indeed, the loan agreement between appellant and Cohn [Third-Party Def. Exh. B], which is the only written evidence of its purpose, expressly provides that the 2,000 shares of AT&T stock were transferred so that:

> "Cohn may contribute the same to the firm of Hertz, Warner & Co. . . . as a contribution of capital by him, or make the same available to the Firm as part of the Firm's assets."

Significantly, upon executing the loan agreement at the request of HW&Co., appellant delivered the securities to HW&Co. and the 2,000 shares of AT&T stock were transferred from the name of appellant directly into the name of HW&Co.

It is fundamental that when property is transferred for a particular purpose, the transferee is merely a bailee of the property until the purpose is fulfilled or the condition met. [*Satterwhite* v. *Harriman National Bank & Trust Co.*, 13 F. Supp. 489 (S.D.N.Y. 1935)] Here, since the purpose for the transfer of the 2,000 shares of AT&T stock from appellant to HW&Co. was to meet Cohn's capital contribution as a partner of HW&Co., title to these securities could not be acquired by HW&Co. if in fact Cohn did not become a partner in the firm. It is submitted that the facts as found by the District Court established beyond peradventure that the 1969 limited partnership agreement [Pltf. Exh. 1] never became effective and that Cohn never became a partner of HW&Co. as a matter of law.

Generally, the question of whether a partnership is created presents a mixed question of law and fact. However, where, as here, the critical facts relating to the existence of a partnership are not in dispute, the issue presented is solely a question of law. [A. R. Bromberg, *Law of Partnership,* § 4(c) (1968)]

It is well settled that a partnership *inter se* does not arise by operation of law but only out of the agreement of the parties. [*Rizika* v. *Potter,* 72 N.Y. Supp. 2d 372 (Sup. Ct. 1947)] Although persons who are not in fact partners may hold themselves out as such and become liable as partners to third persons, this fact does not effect the question of their relationship *inter se.* [*Cassidy* v. *Hall,* 97 N.Y. 159 (1884); *Heck* v. *Voelke,* 95 Misc. 692 (Sup. Ct. 1916)] In *Heck, supra,* the Court noted:

> "The parties held themselves out in some respect as partners erecting an electric sign with their joint names thereon, but these acts in the face of their written contract while it might be evidence to create a liability on the part of both of them to creditors did not change the contractual relation between them from one of employment to one of partnership. *Cassidy* v. *Hall,* 97 N.Y. 159, 169." [*Id.* at 694]

Thus, in determining whether HW&Co. established a valid limited partnership *inter se* as of July 1, 1969, the trial court was required to look to the intention of the parties since it is the expression of that intention which will control the resolution of the critical question of whether Cohn became a partner of HW&Co. [*Keen* v. *Jason,* 19 Misc. 2d 538 (Sup. Ct. 1959); *aff'd* 11 App. Div. 2d 1039 (2d Dept. 1960)]

The best, and indeed the only, expression of the basis upon which the parties contemplated entering into a

partnership can be found in the proposed HW&Co. limited partnership agreement of 1969. [Pltf. Exh. 1] The fact that this agreement never became effective and, accordingly, that the parties intentions were totally frustrated, is amply demonstrated by the record.

First, it is established that at least nineteen intended partners did not sign and accept the proposed July 1, 1969 agreement. (182a; Pltf. Exh. 21) Among these non-signing partners were the so-called Meyer-Blau group which represented approximately $2,000,000 in capital to HW&Co. (45a, at ¶ 35) Of equal importance, Meyer and Blau themselves were to assume 18% of the losses of HW&Co. under the proposed 1969 agreement. (Pltf. Exh. 1) Indeed, throughout the period July 1969 until well into 1970, Meyer and Blau, and the group they represented, consistently repudiated the 1969 agreement and took the position that their rights were governed solely by the 1968 agreement to which Cohn was not a party. [213a, 214a, 217a, 218a; Pltf. Exhs. 19, 25]

The evidence below further disclosed that Meyer had stated to Hertz that unless Hertz agreed to the broad and sweeping changes in the 1969 agreement that Meyer requested, he would withdraw his capital and the capital of the group. (221a, 222a) Hertz testified that he woud never agree to the changes Meyer demanded. (Pltf. Exh. 20, at 36)

The failure of the Meyer-Blau group and of others to sign and accept the proposed 1969 agreement cannot be regarded as a mere formality as the District Court has done. Indeed, in its decision below, the District Court erroneously concluded that it was never a condition of effectiveness that all partners should sign and accept the agreement and that the failure of Meyer and Blau to accept the agreement was not fatal to the existence of the partnership. (68a) In so doing, the District Court totally disregarded the partnership obligations upon which

Cohn and other newly admitted partners relied and which greatly effected the capital structure of the firm and the risk of loss of each of the incoming partners. Indeed, these expressed commitments formed a critical part of the basis on which Cohn signed and obstensibly accepted the terms of the 1969 agreement. Since these terms were never accepted by all the intended signatories to the 1969 agreement and, indeed, expressly repudiated by the Meyer-Blau group, it is apparent that no contractual relationship was created between the proposed partners *inter se.*

It is axiomatic that in order to transform an executory partnership contract into an executed one, it is necessary that the parties do the things that they agreed to do. [68 *C.J.S. Partnership* § 11] It was essential that all the enumerated partners, including Meyer and Blau, sign and accept the proposed 1969 agreement and contribute their capital as represented in order to create the partnership relationship which Cohn intended to enter. The failure of the Meyer-Blau group and others to sign and accept the proposed agreement and to make their required capital contribution was fatal to existence of the partnership which was contemplated by Cohn and expressly represented to him in the proposed agreement. Indeed, Cohn reviewed the agreement before signing it and specifically inquired as to whether Meyer and Blau had signed the agreement.* In short, this impediment prevented the parties from reaching the requisite meeting of minds which would have created an enforceable partnership relationship *inter se.*

The second basic deficiency which prevented the proposed 1969 HW&Co. partnership agreement from becoming

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* The District Court noted that the issue of whether the Meyer-Blau group would be in or out was not a question on Cohn's mind when he made his capital contribution. (68a) Indeed, as Cohn testified, he did not anticipate or have any reason to anticipate anyone not signing the agreement at that time. (140a)

effective arises from the fact that HW&Co. failed to file the agreement with the N.Y.S.E. (Pltf. Exh. 11) Rule 313 of the Rules of the N.Y.S.E. requires that the articles of partnership of member firms be submitted to, and be approved by, the Exchange prior to becoming effective. The evidence discloses that here the agreement in question was not, and indeed could not, be filed and approved by the Exchange since it was never signed by all of the partners.

The final impediment to the validity of the 1969 partnership agreement and Cohn's status as a partner thereunder arises from the requirements of the New York Partnership Law and more specifically Section 91 thereof. In order to create a valid and legally constituted limited partnership under New York law, the parties thereto are required by statute to sign and acknowledge a certificate of limited partnership, setting forth certain information. [N. Y. *Partnership Law* § 91(1)(a)] In substance, the signed and acknowledged certificate must contain critical information about the partnership. Additionally, Section 91(b) requires that the certificate of limited partnership be filed in the office of the County Clerk of the county in which the principal office of the partnership is located and must also be published in two newspapers. It is conceded that the requirements of the New York Partnership Law have not been met. (45a, at ¶¶ 35, 36)

Once again these statutory requirements cannot be regarded as mere formalities. The New York Court of Appeals has held that since limited partnerships, like corporations, are creatures of statutes, it is vital that a limited partnership be evidenced by written articles of partnership. [*Ruzicka* v. *Rager,* 305 N.Y. 191 (1953)] Accordingly, the failure of HW&Co. to execute and file a certificate of limited partnership required by New York law is further compelling evidence that no partnership existed under the

proposed 1969 agreement and that Cohn did not become a partner of the firm thereunder.

HW&Co. violated one further provision of the New York Partnership Law, namely, Section 98(1)(e) which requires the written consent and ratification of all limited partners on the admission of a new general partner. It is not disputed that HW&Co. did not obtain the written consent of all limited partners to the proposed admission of Cohn as a general partner pursuant to the terms of the proposed 1969 limited partnership agreement. (44a, at ¶ 34) HW&Co.'s blatant disregard of still another provision of the New York Partnership Law goes to the heart of Cohn's status as a partner in the firm and compels the conclusion that Cohn never in fact became a partner of HW&Co. under the 1969 agreement or otherwise.

In its decision, the District Court observed that the failure to file the partnership agreement with the N.Y.S.E. or in the County Clerk's Office is of no help since "there is no basis in these defects for invalidating the partnership." (68a) In reaching this conclusion, the District Court analyzed each defect as an isolated fact without considering these facts in conjunction with the more fundamental impediment to the creation of the agreement, i.e., the refusal of certain partners to accept its terms. In taking this approach, the District Court has disregarded the decisional and statutory law of New York and has misinterpreted the thrust of appellant's argument. Simply stated, appellant argued below that the failure to file with the N.Y.S.E. and the County Clerk was additional persuasive proof that the 1969 partnership agreement never became effective and did not bottom its argument on these isolated facts.

In *Rubin* v. *Whitney*, 162 Misc. 821 (Sup. Ct. N.Y. Co., 1937), the court's language in finding the existence of a limited partnership is illuminating. There, in sustaining

plaintiff's claim and holding that a limited partnership did exist, the Court specifically found:

> "The partnership agreement . . . was approved by, and filed with, the New York Stock Exchange. In addition, a copy was filed with the clerk of the county of New York and sufficient notice of the creation of such partnership, as provided by law, was published in the newspaper." [*Id.* at 826]

Here none of these salient facts exist. Applying a parity of reasoning, it is manifest that the absence of these facts coupled with the fundamental failure of certain partners to accept the agreement compels the conclusion that the 1969 limited partnership agreement of HW&Co. failed to become effective to admit Cohn as a partner.

HW&Co., Hertz and Warner Converted Appellant's AT&T Securities

If, as appellant contends, Cohn never became a partner of HW&Co., as a matter of law, HW&Co. was a bailee of the AT&T securities delivered by appellant and occupied a fiduciary capacity towards appellant. Simply stated, HW&Co. was bound to use the AT&T securities for the purpose which appellant parted with them, namely, to fund Cohn's partnership and, if that purpose could not be fulfilled, it was bound to return the securities to appellant.

Satterwhite v. *Harriman National Bank & Trust Co., supra,* presents a strikingly similar situation. There plaintiff delivered 15,000 shares of Standard Oil stock as collateral for a loan of $300,000 from the defendant bank. The court found that at the time of the loan negotiations the bank was in poor financial condition and that its loans had been criticized by federal bank examiners. It further found that the president of the bank had fraudulently induced plaintiff to enter into the loan so as to gain control

over plaintiff's securities which the president could then use for his own purposes.

In holding the Harriman Bank liable for a conversion of plaintiff's securities, Judge Woolsey stated:

> "When the 15,000 shares of stock of the Standard Oil Company of New Jersey, owned by the plaintiff, were sent to and received by the Harriman Bank on April 26, 1932, that bank became bailee of those shares, and had only the right to use them in accordance with the purpose for which the plaintiff had parted with them; namely, as collateral under his loan.
>
> "The Harriman Bank, therefore, at once on receiving those shares came to occupy a fiduciary capacity towards the plaintiff, on the principle that when the property of one man is delivered to another and accepted by the latter, the property can only be used by him in the manner in which it was agreed and intended by its owner that it should be used, and if it is used otherwise the party who received it and so used it, being a fiduciary, must explain how it came to be so used." [*Id.* at 491, 492]

Here, as in *Satterwhite,* HW&Co. only had the right to use the securities delivered by appellant for the purpose for which they were delivered, i.e., to meet Cohn's capital contribution. Having established that no valid partnership existed pursuant to the 1969 agreement under which Cohn was to become a partner, HW&Co.'s continued retention and control of these securities constituted a conversion under New York law.

The New York law on conversion is clear and unambiguous. Any unjustified exercise of dominion over prop-

erty by one who is not the owner thereof and who is not entitled to possession, and, which interferes with the right to possession of another who is lawfully entitled to such possession, constitutes a conversion. [*General Electric Co.* v. *American Export Isbrandtsen Lines, Inc.*, 37 App. Div. 2d 959 (2d Dept. 1971); *Parkway Management Co.* v. *Wolfson,* 32 App. Div. 2d 306 (1st Dept. 1969); *Citizens National Bank* v. *Osetek,* 353 F. Supp. 958 (S.D.N.Y. 1973)]

From the evidence adduced at trial, it is clear that HW&Co. not only interfered with appellant's right to possession of the AT&T securities but, moreover, actually sold the securities with knowledge that a valid partnership had not been formed under the 1969 agreement pursuant to which these securities were delivered. Under these circumstances, HW&Co. and Hertz and Warner, individually, are liable to appellant for conversion.

Appellant's Standing to Sue for Conversion

At trial appellee HW&Co. argued that appellant lacked standing to sue for conversion by reason of the fact that it allegedly surrendered all right, title and interest to the AT&T securities by the terms of the Securities Loan Agreement.* [Third-party Def. Exh. B] This contention lacks substance both in fact and in law.

The evidence below established that the sole purpose for the transfer of the AT&T securities from appellant to HW&Co. was to fund Cohn's partnership contribution. The Securities Loan Agreement was prepared at the request of HW&Co. and by its house counsel so as to facilitate the transfer of the securities from appellant to HW&Co.

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* In *dictum,* the District Court observed that the sweeping waiver was "a powerful point—at least in the absence of fraud." However, since the lower court rejected the fraud claim, it did not rule on the effect of the loan agreement, and impliedly accepted appellant's standing to bring the action. (69a)

Obviously it was never intended that the securities be transferred to Cohn, or for that matter to HW&Co., for any purpose other than to fund Cohn's partnership obligation.

With these facts in mind, it is apparent that when Cohn's partnership failed to materialize, the party entitled to the legal and possessory interest in the securities was appellant. The Securities Loan Agreement which HW&Co. relies upon obviously could not and did not become effective when Cohn failed to become a partner of HW&Co. Indeed, HW&Co. had full knowledge of all the facts surrounding the execution of the agreement and the purpose for which the securities were delivered.

The Supreme Court of Arizona in *Continental National Bank* v. *Evans,* 489 P.2d 15 (1971), passed upon the issue of standing in a strikingly similar action. There, at the request of the defendant bank, legal title to certain stock was transferred to a son by his parents for the purpose of the son pledging the stock to the bank as collateral for a loan. In sustaining the parents' right to sue the bank for conversion, the Court stated:

> "The appellant bank contends that appellees, Andrew and Mary Evans, had no title interest in and to the stock nor right to immediate possession thereof at the time of the sale of the stock by the bank and therefore had no standing to bring the action. With this we disagree.
>
> "The testimony supported the contention that the stock was previously owned and pledged by Andrew and Mary Evans, and was transferred to the name of Robert at the request of the bank. The evidence supports the contention that equitable title, however, remained with Andrew and Mary Evans. The stock, as pledged originally, was owned exclusively by Andrew and Mary Evans, and the note for

> which the stock was pledged was in the name of Robert Evans. The bank, after accepting the stock as collateral, requested that Andrew and Mary Evans transfer legal title to Robert Evans. Although the name on the stock certificate itself was changed to Robert, it was apparent that the appellees as between themselves did not consider title to be exclusively in Robert, but merely legal title to be in his name as security until the loan was repaid. The bank had full knowledge of these facts and cannot now rely exclusively upon the named owner of the stock to defeat the interest of the plaintiffs, Andrew and Mary Evans." [*Id* at 17-18]

Here, as in *Continental,* it was appellant which had the real title and the right to immediate possession of the AT&T stock. Moreover, unlike the situation in *Continental,* title to the AT&T securities here did not in fact pass to Cohn, but the stock was transferred directly from appellant to HW&Co. Furthermore, the purpose of the transfer in the instant case was never consummated whereas in *Continental* the loan was in fact made. Accordingly, *Continental* presents an *a fortiori* case for holding that appellant has standing to maintain this action for conversion against HW&Co., Hertz and Warner.

POINT II

The District Court erred in holding that the principal partners of HW&Co. were not under an affirmative duty to disclose to Cohn material financial information affecting the operations of the firm.

A basic question raised on this appeal is whether, as a matter of law, appellant was fraudulently induced to transfer the 2,000 shares of AT&T stock to HW&Co. ostensibly

as Cohn's capital contribution to the firm. Appellant's position is that HW&Co., Hertz and Warner were under an affirmative duty to disclose to Cohn and appellant all material facts concerning the financial condition of the firm and the status of the proposed partnership agreement prior to the time that Cohn signed the partnership agreement and appellant delivered its AT&T stock.

Significantly, the District Court found, as appellant contended, that HW&Co. was incurring losses in early 1969, returning substantial amounts of limited and subordinated capital and further found that the status of the Meyer-Blau group's participation in the '69 agreement continued as a matter of uncertainty and negotiation. It is not disputed that these facts were not disclosed to Cohn or appellant. (61a, 62a) Moreover, the District Court found that in discussing the partnership with Cohn, Hertz painted an optimistic picture of the firm's future. Indeed, the District Court specifically found that Hertz stressed the high earnings of the last six months of 1968, but did not mention the losses of the early months of '69 that were known to Hertz and Warner and which would eradicate the prior earnings. (62a)

Despite these critical findings of fact, which appellant does not contest, the District Court held that there were no fraudulent statements or omissions to Cohn and that Hertz and Warner were entitled to assume that Cohn could observe the financial problems of the firm. In substance, the District Court, contrary to established principles of partnership and fiduciary law, has ruled that the controlling partners in a N.Y.S.E. member firm had no duty to disclose material financial information to an incoming partner. It is submitted that the District Court's ruling is erroneous since HW&Co., Hertz and Warner stood in a fiduciary relationship to Cohn and were under an affirmative duty to disclose the true financial condition of

the firm. Moreover, in view of the fact that Hertz and Warner knew that appellant would be the source of Cohn's capital, they should have fully disclosed the actual financial condition to appellant, as well.

The clearest expression of the scope of liability for fraudulent misconduct may be found in Section 533 of the *Restatement of Torts*:

> "The maker of a fraudulent misrepresentation in a business transaction is subject to liability to another who acts in justifiable reliance upon it if the misrepresentation, although not made directly to the other, is made to a third person for the purpose of having him repeat its terms or communicate its substance to the other in order to influence the other's conduct in a particular transaction or type of transaction."

Despite their knowledge that appellant would be the source of Cohn's capital, neither Hertz nor Warner disclosed the actual financial condition of HW&Co. or the fact that certain substantial limited partners would not sign and accept the proposed 1969 agreement. While Hertz and Warner did not have any direct contact with appellant, the failure to disclose material information to Cohn was obviously calculated to influence appellant's judgment in advancing the AT&T stock to Cohn.

Significantly, the District Court found that Hertz stressed the high earnings of the last six months of 1968, but did not mention the substantial monthly losses being incurred in early 1969. Clearly in making this partial disclosure, Hertz was under a duty to:

> "make a full and truthful disclosure which will have no tendency to deceive or mislead. One who conveys a false impression by the disclosure of some facts

> and the concealment of others is guilty of fraud, although his statement is true as far as it goes." [37 *C.J.S.* Fraud § 16(c), at 246]

Indeed, Hertz and Warner owed to appellant and Cohn:

> "the duty to speak the whole truth, if they spoke at all, not literally in words, but truthfully in substance. When they undertook to explain the condition of the company they were bound not to deceive . . . either by suppression of the truth or by making statements which, though literally true, were calculated to deceive. They are to be judged by what they intentionally induced (plaintiff) to think not by what they literally said." [*Von Au* v. *Magenheimer,* 126 App. Div. 257 (2nd Dept. 1908); *aff'd* 196 N.Y. 510]

Clearly, having made a partial disclosure about the firm's prior earnings, Hertz and Warner were obligated to go forward and explain the subsequent monthly losses which would eradicate the prior gain. This circuit, through Judge Friendly, has recognized that fundamental principle of disclosure. In the matter of *S.E.C.* v. *Great American Industries, Inc., et al.,* 407 F.2d 453 (2 Cir. 1968), Judge Friendly noted that:

> "One party to a business transaction is under a duty to disclose to the other before the transaction is consummated * * * such additional matters known to him as he knows to be necessary to prevent his partial statement of the facts from being misleading. * * * " *Restatement of Torts,* 24.551(2)(b) (Tent. Draft No. 12, April 27, 1966). [*Id.* at 461]

In his opinion, Judge Friendly concluded that the failure to discharge this duty of disclosure constituted common law fraud. Thus, it is clear that Hertz and Warner's

failure to fully disclose the monthly losses known to them after stressing the gains of the first six months of fiscal '69 culminated in a fraud on appellant.

Hertz and Warner's misconduct is compounded by the utter disregard of their fiduciary obligation to Cohn as an incoming partner. From the inception of the discussions leading toward a partnership opportunity, Hertz and Warner were under a fiduciary duty to disclose all information known to them regarding the operations of HW&Co. [*Libby* v. *L. J. Corp.*, 247 F.2d 78 (D.C. Cir. 1957); *Belcher* v. *Burmingham Trust National Bank*, 348 F. Supp. 61 (D.C. Ala. 1968; *Restatement of Torts,* § 551(2)(a))] Having failed to disclose certain information to Cohn, Hertz and Warner were obligated to explain the reasons why the material facts were not disclosed. [*Matter of Denny,* 5 Misc. 2d 475; *Perlman* v. *Feldman,* 219 F.2d 173] Simply stated, no plausible explanation has been given.

The record below makes it abundantly clear that appellant, as the primary source of Cohn's capital, was the target of the fraud set in motion by Hertz and Warner. By failing to disclose critical facts, Hertz and Warner sought to influence Cohn's judgment and decision on the partnership offer. In acting in this fashion, Hertz and Warner were assured that Cohn could only present an attractive picture to appellant. In clear and convincing language which could have been written for the case at bar, the *Restatement of Torts* observes:

> "*Inducing action between third persons.* The rule stated in this section is applicable not only where the maker's purpose is to influence by its repetition the conduct of another in a transaction with the maker but also where his purpose is to influence the others conduct in a transaction with a third person." [*Restatement of Torts,* § 533, comment a]

Indeed a party "who commits a fraud is liable to whomsoever suffers by the fraud, regardless of whether there is any privity between the person perpetrating the fraud and the party suffering damage by reason of the fraud." [*Cohen* v. *Glassman,* 110 N.Y. Supp. 2d 835 at 837 (Sup. Ct. Kings Co. 1952)] Moreover, it is well settled that "it is not necessary that the deceit should have been practiced directly upon plaintiff. It is sufficient if the initial fraud intended to injure the plaintiff, and caused his damage through intermediate agencies thereby set in motion". [*Cooper* v. *Weissblatt,* 154 Misc. 522, at 526 (Sup. Ct. App. Term, 2d Dept. (1935))]

The language in *Cooper* is particularly applicable to the case at bar. With knowledge that Cohn would go to appellant for his capital contribution, Hertz and Warner misrepresented the financial condition of HW&Co., and failed to disclose that it was sustaining losses. Thus Cohn prevailed upon appellant to loan him 2,000 shares of AT&T stock without having a true financial picture of HW&Co. It is clear that appellant was damaged as the ultimate victim of the fraud set in motion by Hertz and Warner.

In its opinion, the District Court noted that there were no material misrepresentations made to Cohn. (62a) Clearly, this is not the case. A material fact is one to which a reasonable man would attach importance in exercising his judgment in a business transaction. [*Ross* v. *Licht,* 256 F. Supp. 395 (S.D.N.Y. 1967)] In connection with the loan by appellant to Cohn for his capital contribution to HW&Co., one can conceive of no more material facts than the precarious financial condition of the partnership and the questionable status of certain members of the proposed partnership which critically affected the capital structure of the firm.

In light of the applicable law, it is clear that Hertz and Warner were not entitled to assume that the financial problems of the firm were apparent to Cohn and, as a consequence, there were fraudulent misrepresentations and omissions. Thus, the District Court's ruling is clearly erroneous since it totally disregards the fiduciary responsibility which imposed upon Hertz and Warner the affirmative task of disclosing to Cohn the material facts which affected the financial status of the firm. Moreover, the District Court's finding that Hertz and Warner knew that appellant would be the source of Cohn's capital and that Cohn would convey the substance of their conversations, made it incumbent upon Hertz and Warner to fully disclose the actual financial condition of the firm and not merely stress the earnings for the first half of fiscal '68. Clearly, on the facts found by the District Court, Hertz and Warner fraudulently induced appellant to transfer the AT&T stock to HW&Co. as Cohn's capital contribution.

Despite the undisputed fact that Hertz and Warner failed to disclose the actual financial condition of HW&Co., the District Court found that neither Hertz nor Warner intended to mislead Cohn. This holding is clearly erroneous since it is principally predicted upon an obviously subjective analysis of Hertz and Warner's intention. It is well settled that where, as here, nondisclosure is established, the requisite fraudulent intent is imputed to the wrongdoer. As was stated in *Fischer et al.,* v. *Kletz et al.,* 266 F. Supp. 180 (S.D.N.Y. 1967):

> "Liability in a case of nondisclosure is based upon the breach of a duty imposed by the demands of 'good faith and common honesty' . . . The imposition of the duty creates an objective standard against which to measure a defendant's actions and leaves no room for an analysis of the subjective

> considerations inherent in the area of intent. Thus, to base liability in part upon subjective standards of intent of the nondisclosing defendant would blur and weaken the objective basis of impact of nondisclosure upon the plaintiff. In the alternative, if this rationale be deemed unacceptable, it can be persuasively urged that in a non-disclosure case, intent can be sensibly imputed to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false." [*Id.* at 188]

The District Court also ruled that appellant's theory for recovery on the fraud claim, grounded in § 533 of the *Restatement of Torts,* is factually unsupported. (96a) The Court's ruling disregards and, in fact, contradicts its own findings of fact. Appellant testified, and the District Court found, that Cohn told of entering a brokerage business that was "very promising, very lucrative". [Pltf. Exh. 27] Indeed, appellant relied on Cohn, as it was entitled to do, to evaluate Hertz & Warner's partnership offer. The false impression of a "very promising, very lucrative" business was created by the failure of Hertz and Warner to disclose the true financial picture of HW&Co. It is well settled that:

> "one who fails to disclose to another a thing which he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter which he has failed to disclose . . ." [*Fischer* v. *Kletz, supra,* at 185]

It cannot be gainsaid that Cohn would not have agreed to become a partner or prevail on appellant for the loan

of his capital contribution had Hertz and Warner fully disclosed the monthly losses, the withdrawal of substantial capital and the tenuous Meyer-Blau situation. Significantly, the District Court found that Hertz and Warner failed to disclose each of these material facts which affected Cohn's judgment and in turn caused appellant to transfer the AT&T stock to fund Cohn's capital contribution. Thus, the record below, the District Court's own findings of fact and the applicable law, amply support the theory of recovery bottomed upon § 533 of the *Restatement*. Accordingly, the District Court's decision dismissing the fraud claim should be reversed.

POINT III

AT&T is liable to appellant for the return of 2,000 shares of AT&T stock since AT&T breached its statutory duty of inquiry.

Simply stated, the claim against AT&T is predicated upon appellant's continued ownership of the 2,000 shares of stock and AT&T's breach of its statutory duty of inquiry after receipt of a "stop-transfer" order from appellant. Appellant argued below that HW&Co never acquired valid title to these securities since Cohn was never a partner. Thus, HW&Co. held the securities as a bailee, or, at most, constructive trustee for appellant. As the rightful owner of the securities, appellant's "stop-transfer" was effective to impose a duty of inquiry on AT&T which AT&T admittedly ignored at the time it mistakenly and wrongfully transferred the stock to HW&Co. The District Court rejected this contention and ruled that its finding that Cohn was a partner entailed the defeat of the claim against AT&T since appellant was not the true owner of the stock and the transfer to HW&Co. was proper.

Appellant's Continued Ownership

The New York Court of Appeals through Justice Cardozo has stated: "A constructive trust is the formula through which the conscience of equity finds expression." [*Beatty* v. *Guggenheim Exploration Co.*, 225 N.Y. 380, 386 (1919)] It arises where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustifiably enriched if he were permitted to retain it. [*Equity Corp.* v. *Groves,* 294 N.Y. 8 (1945)]

In *Equity*, *supra,* the Court of Appeals made it clear that where a defendant wrongfully obtains stock of another, he holds that stock as a constructive trustee and is under a duty to return it to the rightful owner on demand. As stated by Judge Lehman:

> "The stock would be held by him under a constructive trust to carry out that duty and 'he could not rid himself of that trust' by transfer of the stock to another." [*Id.* at 14]

Since Cohn never became a partner, appellant continued to be the rightful owner of the 2,000 shares of AT&T stock and the subsequent transfer and sale by HW&Co. could not affect appellant's right to the securities. Therefore, as the rightful owner, appellant was entitled to the statutory protection afforded by Sections 8-315 and 8-403 of the New York Uniform Commercial Code.

Efforts to Protect The AT&T Stock

Cohn testified that upon learning of HW&Co.'s extensive losses, he and Held visited the law firm of Javits & Javits to obtain legal advice as to their status in the firm. Javits & Javits expressed the preliminary opinion that Cohn and Held had been fraudulently induced to sign the proposed 1969 agreement, but also stated that sub-

stantial proof of fraud would be required to reach a definitive conclusion. (92a, 93a, 94a, 170a)

Upon receiving this advice, Cohn attempted to obtain further information and proof. He checked into the status of capital accounts and became aware of a substantial deficiency in Meyer and Blau's accounts, among others. In addition, Cohn, for the first time, discovered that Meyer and Blau, their group and other partners had not signed and accepted the proposed 1969 agreement. Moreover, Cohn's inquiry disclosed that Warner, without authority or notification, and in breach of his partnership obligation, had withdrawn 2,000 shares of Republic National Bank of New York common stock from his capital account. (94a; Pltf. Exhs. 12, 25)

Upon discovering these critical facts, Cohn sought ways to protect the AT&T stock then registered in the name of HW&Co. Cohn rejected suggestions that the stock be physically removed from the premises of HW&Co. However, on May 1, 1970, with Cohn's knowledge and acquiescence, Sadlier transferred twenty 100 share certificates of AT&T stock in the name of HW&Co. into a 2,000 share stock certificate in the name of appellant. The purpose of the transfer was to prevent the negotiability of the stock without prior notice to Cohn and/or appellant. The "stop transfer" was placed on the securities which were never removed from the premises of HW&Co. (95a, 96a; Pltf. Exh. 10; Pltf. Exh. 12; 41a, at ¶ 10)

In its opinion, the District Court commented that there was no justification for Cohn's conduct despite the fact that he acted on advice of counsel, after discovery of losses and deficiencies in partners' capital accounts. It is submitted that the District Court's erroneous conclusion that Cohn's conduct was "a blatant act of lawlessness" completely disregards the undisputed facts and applicable law.

At the time the stock was retransferred, the facts uncovered by Cohn and Held established that a fraud was practiced upon them and upon all purported incoming partners of HW&Co. under the 1969 partnership agreement. The law has long recognized the right of a party to recover from one unlawfully in possession of property to which he has a claim of ownership. Thus, as stated by Mr. Justice Douglas in *Davis* v. *United States,* 328 U.S. 582 (1945):

> "... an owner of property who seeks to take it from one who is unlawfully in possession has long been recognized to have greater leeway than he would have but for his right of possession. The claim of ownership will even justify a trespass and warrant steps otherwise unlawful." [*Id.* at 591]

Similarly, Professor Williston in his treatise on contracts, states the proposition that a seller who is defrauded of his property may not only sue for trover or replevin but, "if the seller can regain possession of the goods peaceably without the aid of a court, he may do so, and thereby is revested with title." [11 *Williston on Contracts* § 1370 (3d ed. 1969)]

The concept of permitting an owner to reclaim possession of a security which has been wrongfully transferred finds continued validity and effect in Section 8-315 of the U.C.C. which, in pertinent part, provides:

> "(1) Any person against whom the transfer of a security is wrongful for any reason, including his incapacity, may against anyone except a bona fide purchaser reclaim possession of the security or obtain possession of any new security evidencing all or part of the same rights or have damages."

The practice commentary to this section of the Code is particularly illuminating and strikingly applicable to the case at bar. There, Professor Israels notes that:

> "A 'person against whom the transfer of a security is wrongful' includes not only one who lost it or from whom it was stolen . . . but also one who parted with it voluntarily on the basis of fraudulent or innocent misrepresentation or under mistake of fact . . ."

Thus Cohn could have reclaimed possession, but did not go that far. With knowledge of the fraud and that substantial capital had been removed from the firm, Cohn did not remove the AT&T securities from HW&Co. but instead merely retransferred record ownership to appellant so as to preserve the status quo. Under the circumstances, it is submitted that this transfer was not only warranted but in fact had the effect of placing the record ownership in the securities in question back into appellant where it rightfully belonged.

The Wrongful Transfer

It was in this factual setting that appellant thereafter placed the written "stop transfer" on the 2,000 shares of AT&T stock in an effort to protect itself from an unwarranted and illegal sale of HW&Co. Section 8-403 of the U.C.C. provides in pertinent part:

> "(1) An issuer to whom a security is presented for registration is under a duty to inquire into adverse claims if
>
> > "(a) a written notification of an adverse claim is received at a time and in a manner which affords the issuer a reasonable opportunity to act on it prior to the issuance of a new, reissued or

reregistered security and the notification identifies the claimant, the registered owner and the issue of which the security is a part and provides an address for communications directed to the claimant."

Clearly, the "stop transfer" constituted an adverse claim which imposed a duty on AT&T to inquire into the basis for the "stop" and the facts and circumstances surrounding the request for transfer to HW&Co. AT&T has candidly admitted that it made no inquiry or investigation, as appellant submits it was required to do, but merely relied upon the indemnity agreement provided by HW&Co. It is submitted that had the proper inquiry been made, appellant could have demonstrated its superior right to the securities, and at the least, AT&T could have deposited the securities in court or refused to retransfer them to HW&Co. Having elected to rely upon HW&Co.'s indemnity, AT&T should not now be heard to complain that its connection to the transaction was too remote as to justify liability on its part.

AT&T's action in disregarding appellant's "stop transfer" becomes more aggravated since at the time the securities were presented for transfer back into the name of HW&Co., AT&T was presented with a letter from Joel Held which traced the chronology of the record ownership of the securities (Pltf. Exh. 15) and advised AT&T of the peculiar "nature and complexity of the situation surrounding . . . the 2,000 shares of stock." (Pltf. Exh. 15; 42a, at ¶ 20) This letter should have put AT&T on further notice that to permit a transfer of the securities could subject it to liability to appellant as record owner. It is submitted that by disregarding the "stop transfer" and the facts set forth in the Held letter, AT&T acted at its peril and must accept the consequences which flow from the wrongful transfer.

CONCLUSION

On this appeal, appellant does not take issue with the District Court's factual findings but respectfully submits that the court erred in its application of the law to these findings of fact. Appellant submits that Cohn never became a partner of HW&Co. and that the AT&T stock which appellant transferred to HW&Co. to fund Cohn's capital contribution was wrongfully and fraudulently converted by HW&Co. Indeed, since title to the stock remained in appellant, AT&T's transfer over a "stop transfer" order renders it liable for the return of the stock or its equivalent value. Accordingly, it is respectfully submitted that the judgment of the District Court dismissing appellant's claims should be reversed.

Respectfully submitted,

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